

FULL DISCLOSURE: MONTHLY BRIEFING ON EU CORPORATE TRANSPARENCY REGULATION
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(Financial) Opportunities of European sustainability reporting rules for small businesses

Small and medium enterprises (SMEs) are the backbone of our economy. They are a big source of innovation, employment and face great growth opportunities towards a sustainable and low carbon economy. While the transition is already underway, SMEs must be considered adequately in the discussions about sustainability reporting rules. Meanwhile, many SMEs face major technological and regulatory changes and need to secure finance for transformation. **To remain competitive, SMEs will need to invest in their own transformation.** The EU plans to mobilise EUR 1 billion public investments annually¹ for support. Yet, harnessing these opportunities will also depend on SMEs' ability to provide the right data on sustainability.

Until now, SMEs have largely been left out from sustainability reporting requirements. However, this is changing due to growing demand for sustainability-related data and information from banks and investors as well as companies at the top of value chains. They are increasingly aligning their business models, strategies and portfolios to become climate neutral. In order to manage their risks and strategies accordingly, they need **sustainability-related data and information** from their clients and suppliers, which are often SMEs. Thus, SMEs play an increasingly important role in this debate and at the same time, they themselves can profit from new reporting requirements.

"From the 'banks' perspective, it is important to have sustainability data from SMEs. Mainly in the sectors that are sensitive to climate risks. It is needed to support their transition and also for our own risks assessment and compliance with regulatory disclosure requirements. The Corporate Sustainability Reporting Directive (CSRD) is already a major step forward, but we hope the forthcoming interinstitutional negotiations will bring an even bigger ambition in the future Directive to include SMEs from those sectors," describes Antoni Ballabriga, Global Head of Responsible Business at BBVA and Chair of the Sustainable Finance Working Group at the European Banking Federation.

Transparency as an asset to SMEs and capital markets

Besides the urgency to adapt to the needs and demands of investors and creditors to maintain their current business, **the economic transformation towards climate neutrality** will create new market opportunities, and it is vital for SMEs to be able to harness them.

¹ Alliance for Corporate Transparency: "Investing graph". https://www.allianceforcorporatetransparency.org/assets/2101-Investing_graph_source-EC.jpg. Last retrieved: 2021-06-11.

The Business Commission for Sustainable Development reported that meeting the UN Sustainable Development Goals (SDGs) would create **market opportunities of EUR 10 trillion² per year by 2030**. Similarly, as shown in a study by the Carbon Disclosure Project (CDP) from 2020³, the value of low carbon opportunities such as higher demand for electric vehicles and green infrastructure identified by 882 European companies reached EUR 1.22 trillion, which was more than six times higher than the investment costs of EUR 192 billion.

SMEs' ability to work with sustainability data will be key for acquiring new customers, embracing technological changes necessary for succeeding in this rapidly evolving environment and avoiding legislative shocks.

Many SMEs are already not only adapting but leading in seizing these opportunities. Such outstanding businesses have a huge head start, enabling them to harness the opportunities presented by the transformation and advance their business models to the next stage. They also benefit from **reduced costs by optimising energy and resource use, attracting and retaining talent⁴ or being better placed in terms of seeking loans or investment**. For those, who are lacking behind, it is essential to understand the opportunities, of sustainability reporting.

“The majority of German SMEs, that publish a CSR-report, make use of the German Sustainability Codex (DNK). The positive aspect of this is that companies report to a set of standardized questions. However, the answers are mainly qualitative, which is difficult to process and insufficient in its informative value. **For the finance sector to support SMEs in their transformation process, we would need to see standardized and quantitative reporting for SMEs** at least in sectors, highly relevant for the transformation”, says Franziska Schütze of the German Institute for Economic Research and coordinator of the Sustainable Finance Research Plattform⁵.

Several EU initiatives aim to **harmonise and extend current sustainability reporting**, e.g. the **EU Taxonomy Regulation**, the **Sustainable Finance Disclosure Regulation** or the proposal for a **new CSRD**. Recent research findings underline that “[...] disclosure of pertinent non-financial information has been shown to significantly reduce information asymmetry [...], and mandatory non-financial disclosure contributes to the efficiency of capital markets.”

But also companies **profit from disclosure regulation**. Findings of the German Science Platform on Sustainable Finance further show that “compared to voluntary disclosure, mandatory corporate disclosure of greenhouse gas emissions leads to significantly greater emission reductions by the companies concerned” and that “company-related greenhouse gas emissions are incorporated in the company evaluation, with the result for companies with particularly high emissions having lower market values”.⁶

² United Nations (2019): “Roadmap for Financing the 2030 Agenda for Sustainable Development. 2019-2021”. https://www.un.org/sustainabledevelopment/wp-content/uploads/2019/07/EXEC.SUM_SG-Roadmap-Financing-SDGs-July-2019.pdf. Last retrieved: 2021-06-11.

³ CDP (2020): “Doubling Down: Europe’s Low-Carbon Investment Opportunity. February 2020”. https://6fefcbb86e61af1b2fc4-c70d8ead6ced550b4d987d7c03fcdd1d.ssl.cf3.rackcdn.com/cms/reports/documents/000/004/958/original/Doubling_down_Europe's_low_carbon_investment_opportunity.pdf?1586852291. Last retrieved: 2021-06-11.

⁴ Governance Accountability Institute inc. (2019): “Millennials Really Do Want To Work for Environmentally-Sustainable Companies, According to a New Survey of Large Company Employees”. Last retrieved: 2021-06-11.

⁵ See: www.wpsf.de.

⁶ https://wpsf.de/wp-content/uploads/2021/04/WPSF_PolicyBrief_7-2021_Materiality.pdf. Last retrieved: 2021-07-22.

The cost for SMEs to be excluded from reporting requirements

The recent EU CSRD proposal seeks to involve small businesses for the first time. Previously, the **EU Non-Financial Reporting Directive (NFRD)** applied only to large listed companies, banks and insurers with more than 500 employees, thus limiting its impact to 2,000 companies⁷ EU-wide. With the new draft on the table, reporting obligations will involve SMEs listed on stock markets, as well as all large companies (both private and listed), as is already the case in Denmark, Greece, Iceland, Spain and Sweden (an analysis of the key changes proposed in the reform presented in April 2021 can be found here⁸).

Even if the change in scope appears to be significant, it still affects **less than 1% of companies in the EU**. Left out of the scope is another 6%, which is considered private (not listed) SMEs and the large majority of 93%, which are microenterprises that are too small to be subject to reporting legislation.

SMEs in the EU – green business opportunities and access to finance

- Together, **SMEs make up over 99% of all enterprises in the EU**. They account for over two-thirds of total employment and contribute about 56% of the total turnover in the EU.
- Only 3 % of EU start-ups go on scale up, but they are Europe's job creation champions.
- While young SMEs that scale up represent just a tiny minority of all start-ups, they offer a **key source of radical and disruptive innovations** and **disproportionately create jobs** in the market. For example, while on average only 4% of micro-sized start-ups grow in this way, they contribute to the creation of between 22% (The Netherlands) and 53% (France) of jobs in their category.
- There is evidence that **lack of access to appropriate external finance** can act as a **barrier to growth¹ and innovation in SMEs**. Even more so in green business opportunities, more than a quarter of SMEs that have undertaken activities related to the circular economy claimed difficulties accessing finance in the Eurobarometer survey¹.

Source: Eco-innovation in SMEs, Future Brief 22, European Commission, DG Environment

⁷ European Commission (2021): "Fitness Check on the EU framework for public reporting by companies". <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021SC0081&from=EN>. Last retrieved: 2021-06-11.

⁸ Alliance for Corporate Transparency (2021): "On the Corporate Sustainability Reporting Directive (NFRD reform) proposal: most promising changes and caveats". <https://www.allianceforcorporatetransparency.org/news/on-the-draft-sustainability-reporting-directive-nfrd-reform-proposal-most-promising-changes-and-caveats.html>. Last retrieved: 2021-06-11.

Investors, accounting organisations and NGOs raised two concerns⁹ with the EU Commission's way of **defining the scope of companies** required to report sustainability data:

- (1) Significant impacts of companies on the environment and society do not depend on their size or legal status.
- (2) Redirection of investments to support the transition to a low-carbon economy is not limited to assets listed on stock exchanges.

To address these concerns, the German Sustainable Finance Advisory Council to the Government (SFB), demands a **definition of "high-risk" sectors**. Companies operating in sectors that are especially relevant for the transformation,

- (1) due to a high impact on the environment and society or
- (2) due to a high exposure to risks resulting from sustainability crises and the transformation,

should also be covered in disclosure regulation.¹⁰

Adding this high-risk approach to the current scope of the EU CSRD is not only paramount from an investor's perspective but also for the affected SMEs themselves. They face being disadvantaged compared to their larger competitors and listed SMEs that will instead be covered by the new rules. Any divergence of rules between listed and non-listed companies also risks adding another barrier to small businesses seeking to expand – companies who are considering raising capital by listing their shares or bonds on stock exchanges. It is important to avoid introducing such disincentives – both for SMEs themselves and for the operation of our capital markets.

EU standardisation of corporate sustainability reporting helps to reduce the burden for SMEs

Data by the **Global Reporting Initiative**¹¹ (one of the most common voluntary reporting standards) shows that only **10-15% of companies using their standards are SMEs**. This is understandable, given the complexity and variety of existing reporting frameworks – which combined propose over 5,000 key performance indicators (KPIs). This leads to competing demands for data from customers and financial institutions. All of this makes sustainability data gathering and using extremely challenging and costly for SMEs with limited financial and human resources.

The EU initiative rightly seeks to address this problem by providing clear reporting standards that identify which data companies – as well as banks and investors – should focus on. More broadly, standards will provide a map and compass allowing companies to understand and navigate through the storm of technological development, market demand and regulatory changes on the horizon. Small businesses stand to benefit most.

⁹ Accountancy Europe (2020): "Joint statement on the revision of the non-financial reporting directive in the context of Covid-19". <https://www.accountancyeurope.eu/good-governance-sustainability/joint-statement-on-the-revision-of-the-non-financial-reporting-directive-in-the-context-of-covid-19/>. Last retrieved: 2021-06-11.

¹⁰ Sustainable Finance-Beirat der Bundesregierung (2021): „Shifting the Trillions: Ein nachhaltiges Finanzsystem für die Große Transformation“. https://sustainable-finance-beirat.de/wp-content/uploads/2021/02/210224_SFB_-Abschlussbericht-2021.pdf. Last retrieved: 2021-07-07.

¹¹ Global Reporting Initiative (2021): "Sustainability Disclosure Database". <https://database.globalreporting.org/search/>. Last retrieved: 2021-06-11.

As pointed out by Sara Foršek, Sustainability officer from Raiffeisenbank Austria d.d.: “SMEs and those not supported by international parent companies do not have a clear understanding of what is expected from them concerning sustainability data. A resulting common problem is that disclosed information is often not standardised and thus not comparable.”

The European Commission proposed¹² that a **simplified standard for SMEs** should be developed. Such a standard will go a long way in making it easier for SMEs to report on sustainability and reduce administrative costs.

To achieve this goal, the mandatory standards should **specify essential sustainability indicators** that can be reasonably reported by SMEs, and – critically – supporting methodologies and tools allowing their easy calculation. This concerns in particular:

- greenhouse gas emissions,
- energy intensity,
- information concerning activities and use of resources linked to heightened risks of impacts on climate, biodiversity and deforestation,
- clear guidance for reporting on climate transition plans, estimated future risks and sustainable activities,
- human rights due diligence, and
- meaningful workforce indicators (large companies often require a plethora of social data and confirmations on compliance with fundamental labour rights from their suppliers, but the requested information is often of questionable value).

The limitation of mandatory reporting to SMEs in high-risk sectors could further reduce the administration efforts for non-affected companies.

Conclusion

A tipping point has now been reached from an older approach of simply exempting small businesses from sustainability reporting rules to one today, which recognises the positive advantages of ensuring SMEs are not left behind. Small businesses cannot avoid the major forces transforming our economies towards a low carbon future – and need to embrace them or risk disappearing altogether. The cost of sustainability reporting is seen to pay itself back to the company by up to six times, as CDP demonstrated. **Sustainability data is already essential for companies** to benefit from a sharply rising proportion of all investment funds as well as, for example, Covid recovery finance around the world. Without relevant sustainability reporting, small businesses find themselves at a competitive disadvantage, missing new market opportunities and being prevented from accessing resources for the development of new technological solutions. Only by becoming part of the sustainability transition will SMEs be the source of sustainable growth for the future.

The EU’s new CSRD has recognised these arguments, involving small businesses for the first time, but ensuring that **only simplified standards would apply to SMEs**. Following the reasons outlined in this article, it is right to argue that the interest of small businesses would be better served by extending the

¹² European Commission (2021): Keynote speech at conference 'Proposal for a Corporate Sustainability Reporting Directive: the way forward". https://ec.europa.eu/commission/commissioners/2019-2024/mcguinness/announcements/keynote-speech-conference-proposal-corporate-sustainability-reporting-directive-way-forward_en. Last retrieved: 2021-06-11.

scope of the directive itself and providing them with certainty vis-a-vis larger companies by laying down safeguards and clear, simplified standards.

To every small business owner across Europe today: It is important to recognise how many of your fellow SMEs are adopting these practices and are succeeding by doing so. You have won the argument that new EU requirements must be proportionate to your ability to meet them – but it is time to add your own voice to ensure all small businesses can be included to secure your own place in a sustainable future.

This article is part of our series “**Full Disclosure: Monthly Briefing on EU Corporate Transparency Regulation**”, in which we aim to shed light on the need for and benefits of forward-looking reporting requirements in a changing EU regulatory environment. The series includes to date:

- **Climate transition plans: How EU standards can help companies to focus on the right data** (June Issue): <https://germanwatch.org/de/20333>
- **The EU Sustainable Finance April package and how EU sustainability reporting standards fit in** (May Issue): <https://www.germanwatch.org/de/20152>
- **What needs to be reported on sustainability-related governance?** (April Issue): <https://germanwatch.org/en/20081>
- **Reform of the EU Non-financial Reporting Directive: A Push Towards Future-proof Reporting Obligations** (March Issue): <https://www.germanwatch.org/en/19990>

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